

Investment Market Commentary FYTD 2015: December 31, 2014

The strength of the U.S. economy is the exception on the global stage and as a result U.S. stocks have been the highest performing asset class. U.S. job growth has been steady in the second half of calendar year 2014, with most months creating higher than 200,000 new jobs and the unemployment rate is now below 6%. The question now is can the U.S. economy shrug off the slowdown the rest of the world is experiencing and can the lower gasoline prices increase domestic consumption enough to create upward pressure on wages, further strengthening the U.S. economy. If not, we may see U.S. stocks under pressure in the not too distant future.

Investment returns have been negatively impacted by the global economic slowdown. European economies are in recession and Japan is still struggling to climb out of its twenty-five year economic slump. In addition, the emerging economies have slowed due to a decrease in commodity prices caused by the economic slowdown in China. The U.S. dollar has appreciated against almost all other global currencies, which has been great for domestic consumption, but not good if you own assets denominated in foreign currencies like the KRS non-U.S. equity and emerging market equity portfolios. These two portfolios have been especially hard hit by both the economic slowdown globally, but also the currency depreciation versus the U.S. dollar.

Inflation sensitive assets have also been hurt by the global slowdown and the prospects of the U.S. Federal Reserve raising interest rates later in 2015. Deflation is more of the concern globally and there are no signs of inflation in the U.S. as the Federal Reserve completed its quantitative easing program and have now given the markets guidance on when it intends to start raising interest rates.

Treasury yields have decreased since June 30, 2014, which is somewhat of a disconnect with what the U.S. stock market is telling investors (yields should rise as stocks rise and go down as stocks go down). This may be because global interest rates are so low and U.S. rates are somewhat tethered to them. High yield fixed income has been hurt by what has occurred with energy prices, particularly oil. Energy companies make up 20% of the high yield market and as oil has declined so has the price of the bonds of high yield issuers in the energy industry. This sell off is likely overdone and may create investment opportunities, but in the mean time the entire high yield debt space has been negatively affected.

Absolute Return strategies as a group had their most challenged period since 2008. While their performance is positive, the up and down equity market of recent months, oil price drop and its affect on credit fixed income, the low interest rate environment globally, and the rally in the U.S. dollar have provided a tough backdrop for hedge funds to make money except for global macro and systematic trading strategies, which should have been able to capture the price move in oil and the U.S. dollar. Hedge funds should be entering into a period more opportunistic for them as the correlation between stocks decrease and the capital markets return to

being driven by fundamentals and not the actions of the Federal Reserve. Portfolio managers in hedge fund strategies are able to add value by picking correct sectors, strategies, and individual company names when those things don't all move in tandem.

Commercial real estate, or what institutional investors refer to as core real estate is priced at fair value. It's hard to imagine an economic scenario that allows commercial real estate to continue to go up in value especially as the Federal Reserve is set to raise interest rates later in 2015. The better value in the real estate markets are properties where owners and property managers can rehab and add value through structural investments in or repurposing existing properties making them more valuable to tenants or potential purchasers.

Private equity realization of returns has been stronger with the IPO markets being robust for the past twelve months. As firms seek to utilize the robust IPO market or sell companies to strategic buyers investors are starting to see quality returns. Along the same lines, guidance from the Federal Reserve with respect to historically low short-term interest rates has allowed underlying portfolio companies to clean up their balance sheets making them more valuable on a cash flow basis and to potential buyers. Entering into new private equity transactions at this time may turn out to be expensive depending on the direction of the U.S. public equity market and how aggressively interest rates move higher.

KRS Investment Portfolio FYTD 2015

The composite KRS Pension portfolio has not performed well on an absolute basis (-0.92%), nor relative to its benchmark (-0.58%) for the fiscal year through December 2014. The U.S. equity markets remain a bright spot, though less so than the prior twenty-four months. U.S. stocks have been volatile the first half of the fiscal year and remain so. KRS U.S. public equity has returned 4.22%, with large caps stocks performing better than mid cap and small cap stocks. Other positive contributors to performance were real estate 3.13%, private equity 2.25%, absolute return 0.75%, and fixed income 0.58%. Negative contributors to performance were emerging market equity -8.69%, non-U.S. public equity -8.34%, and real return assets -4.81%. Relative to each sector's benchmark there was only one positive contributor, public equity (+0.16%) and this was due to the outperformance of the non-U.S. equity portfolio versus its benchmark. The U.S. equity portion of the public equity has not done well relative to benchmark because passive management has outperformed active management and growth stocks have outperformed value stocks, which has been a headwind as KRS uses active management with a value tilt within its U.S. equity allocation. All other asset classes in the portfolio have not done well relative to their benchmarks: real estate (-2.64%), real return (-1.92%), absolute return (-1.40%), and fixed income (-0.73%). The underperformance of fixed income is due to having more credit oriented fixed income instead of interest rate sensitive fixed income versus the benchmark. Real return underperformance is due to the PIMCO All Asset position grossly underperforming its benchmark and the

absolute return underperformance is due to a single hedge fund manager having a difficult start to the fiscal year. The performance variance in the KRS real estate portfolio is due to the conservative debt/credit nature of the portfolio's investments, the early stages of capital deployment, and the allocation decisions of the real estate portfolio within the transition to a larger real asset mandate. The KRS investment team looks forward to reversing the current trajectory of the portfolio and finishing the fiscal year strong.